LODI CITY COUNCIL

Carnegie Forum
305 West Pine Street, Lodi

"SHIRTSLEEVE" SESSION

Date: November 28, 2006

Time: 7:00 a.m.

For information regarding this Agenda please contact:
Randi Johl
City Clerk
Telephone: (209) 333-6702

NOTE: All staff reports or other written documentation relating to each item of business referred to on the agenda are on file in the Office of the City Clerk and are available for public inspection. If requested, the agenda shall be made available in appropriate alternative formats to persons with a disability, as required by Section 202 of the Americans with Disabilities Act of 1990 (42 U.S.C. Sec. 12132), and the federal rules and regulations adopted in implementation thereof. To make a request for disability-related modification or accommodation contact the City Clerk's Office as soon as possible and at least 24 hours prior to the meeting date.

Informal Informational Meeting

A. Roll call by City Clerk

B. Topic(s)

B-1 Electric Reserve Fund Study Overview (EUD)

C. Comments by public on non-agenda items

D. Adjournment

Pursuant to Section 54954.2(a) of the Government Code of the State of California, this agenda was posted at least 72 hours in advance of the scheduled meeting at a public place freely accessible to the public 24 hours a day.

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Randi Johl
City Clerk

AGENDA ITEM B-01

CITY OF LODI
COUNCIL COMMUNICATION

AGENDA TITLE: **Electric Reserve Fund Study Overview (EUD)**

MEETING DATE: **November 28, 2006**

PREPARED BY: **Electric Utility Director**

RECOMMENDED ACTION: Receive report by Navigant Consulting Inc. regarding the appropriate level of cash reserves to be maintained by the Electric Utility Department.

BACKGROUND INFORMATION: Navigant Consulting Inc. was retained by the City to make a recommendation regarding the appropriate level of cash reserves for the Electric Utility Department. Mr. Ron Stassi of Navigant will be available to summarize the report to the City Council at its November 28, 2006, Shirtsleeve session.

FISCAL IMPACT: None at this time.

FUNDING: Not applicable.

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George F. Morrow
Electric Utility Director

Attachment

APPROVED: _____
Blair King, City Manager

NAVIGANT CONSULTING

One California Plaza
300 South Grand Avenue
29th Floor
Los Angeles, CA 90071
213-670-3200 phone
213-670-3250 fax

November 21, 2006

George F. Morrow
Electric Utility Director
City of Lodi
1331 S. Ham Lane
Lodi, CA 95242-3995

Re: Lodi Fund Reserve Final Report

Dear George:

Attached is a copy of the Lodi Fund Reserve Final Report. It was a pleasure to work with you and your staff on this assignment. I look forward to meeting with the City of Lodi City Council on November 28th. If you need anything in the meantime, please give me a call.

Sincerely,

Ron Stassi
Ronald V. Stassi

Attachment

DETERMINATION OF PRUDENT AND APPROPRIATE CASH RESERVE LEVELS FOR LODI ELECTRIC UTILITY

NOVEMBER 2006

PURPOSE

To determine prudent and appropriate levels of cash reserves that should be maintained by Lodi Electric Utility.

BACKGROUND

In Lodi, the cost of operating and maintaining its electrical system is supported primarily by retail rates. Historically, these costs have had some degree of predictability, however, in recent times price volatility as a result of power scarcity, natural gas price increases and environmental compliance issues have created periods of price instability. Such effects have been most notable in energy markets over the past few years as city councils and utility boards have struggled with rate setting decisions that relate to maintaining the financial health of their utilities. Unlike those utilities that have strong cash positions, Lodi Electric Utility finds itself in a cash poor position as a result of some past decisions relating to fuel markets, purchased power and rates.

Lodi Electric Utility recognizes that maintaining adequate cash reserves is an operational need as well as a primary determinate of its bond ratings. Since Lodi Electric Utility is a member of the Northern California Power Agency (NCPA), it is faced with the additional consideration that its financial situation also has an effect upon NCPA's future financings , bond ratings and costs.

Since the establishment of reserves is often viewed as a policy issue, the determination of appropriate reserve levels is best decided by the City Council. For that reason, Lodi Electric Utility has undertaken this study to develop a criteria and recommendations to advise the City Council on the level of reserves needed to maintain the fiscal health of its electric system.

STUDY APPROACH

The process used to develop the recommendations found in this report included:

- Consideration of the contingencies and probabilities of Lodi Electric Utility encountering those contingencies
- A review of reserves levels in the electric utility industry
- A limited survey of the practices employed by comparably sized California municipal utilities
- Discussions with Lodi Electric staff.

The focus of this study is not on those reserve balances associated with the issuance of bonds, but rather on those more commonly set-aside by businesses for general, particular or contingency purposes. It is also important to note that this study is not designed to determine the adequacy of revenues generated from utility billings to support reserve funds. It is presented on a revenue-neutral basis and does not address utility rates or revenues.

ANALYSIS

Cash reserves are highly liquid assets that are set aside by business organizations to provide funds to address operational contingencies. Factors that guide the types and sizes of reserves vary from organization to organization and business to business. Both business and governmental organizations that are well managed generally maintain cash reserves in amounts appropriate for the risks associated with their line of work. The size of the reserve is generally based upon an assessment of specific contingencies that might require the use of fund reserves and the probability of such events occurring.

Reserves are often classified in the following manner:

Operating Reserves

Most utilities maintain Operating Reserves in one form or another. The amount or level of reserves is generally based upon providing "coverage" of expenses over a number of days. Typically, Operating Reserves are sized to cover 30-60 days' expenses. Operating Reserves represent the most common form of cash reserves in place in the utility industry.

Capital Reserves

A second type of reserve that is often encountered among capital intensive businesses is Capital Reserves. Irrespective of whether they are governmental or investor-owned, utilities by their very nature are highly capital intensive. That is, a lot of high cost infrastructure is necessary for a utility to function properly. As a result, utilities often issue bonds to finance a "plant" that will last for many years. As well, Capital Reserve Funds are often set up to fund the emergency replacement of expensive capital equipment. For example, an electric utility may establish a capital reserve fund at an amount sufficient to fund the replacement of a failure of a turbine-generator, its largest system contingency. Capital Reserves that are called upon to fund capital projects are generally replenished from subsequent bond issues or rate revenue.

General Reserves

General Reserves are often established as a "catch all" to address either a wide range of typically unspecified / undefined contingencies. Because they are not created with specific intent, they are often subject to criticism particularly when funded with ratepayer dollars. It is not recommended that Lodi Electric Utility consider establishing General Reserves at this time.

Special/Specific Reserves

Reserves are often created and designated for specific purposes. For example, in the last decade many California municipal electric utilities established temporary reserves to help ensure their competitiveness in the volatile restructured electric utility environment. These reserves were often labeled "Stranded Investment Funds," "Competitiveness Funds," "Rate Stabilization Reserves," or other similar titles which are somewhat descriptive of their purpose.

Debt Service or Bond Reserves

Issuers of debt sometimes maintain a debt reserve fund equal to some multiple of the average periodic debt service payment. This requirement could even be formalized in the form of a bond resolution associated with the borrowing. Utility debt service payments generally become due twice a year. The existence of a debt service reserve policy and associated funding could also send a favorable signal to investors and rating agencies. If Operating Reserves take debt service obligations into account, the establishment of a debt service reserve is generally not warranted.

DISCUSSION

Operating Reserves, sometimes referred to as working capital are well suited for addressing normal variations from planned or budgeted cash flows, as well as addressing contingencies that may arise from utility operations. They are generally established by formal policy. Restricted cash reserves set equal to 30 to 60 days operating costs are typical in the electric utility industry. Many California municipal utilities have historically conducted business with only operating reserves and such additional cash reserves as might be required under bond covenants.

Capital Reserves are often appropriate for utilities that own large power facilities. Also, some utilities set aside capital reserves associated with their participation in shared generation or transmission projects, such as those sponsored by NCPA. Beyond the requirement to fund its share of capital reserves for joint power facilities, no need has been noted for Lodi Electric Utility to establish capital reserves for additional power supply. There are, however, capital need contingencies associated with its on-site infrastructure.

The establishment of a Special Reserve to ensure that Lodi Electric Utility "remains competitive" during this period following the unsuccessful restructuring of the electric utility industry in California warrants some discussion. During early 2001 power price volatility exceeded what anyone could have predicted. Even though California power markets have now somewhat stabilized, albeit at higher levels than those of ten tears ago, consideration should still be given to maintaining a special reserve to ensure Lodi Electric rate competitiveness at least for the next several years. However, just like ten years ago when electrical restructuring was in its infancy, it is not wise for anyone to

pretend to have knowledge of what future power costs might be. Still, the basis for setting the level of special reserves remains the same – risk management.

Establishment of a Debt Service Reserve could have value as an indication to rating agencies that Lodi Electric Utility is taking its recent downgrading by Fitch Ratings seriously and that among the steps it is taking to strengthen its cash position, it is formulating one to specifically address lender concerns.

COMPARISON WITH LOCAL PRACTICES

The attached limited survey, Appendix A, illustrates how each of five similar sized and larger California municipalities address fund reserves. It is note worthy that few have formal council policies that address the requirement for and level of cash reserves, but that all maintain operating reserves to some degree. For those utilities that have council directed policies with respect to operating reserves, the levels range from 30 to 45.6 days. (The 45.6-day period results from a policy requiring that operating reserves be set at 1/8th of annual expenses.) Operating reserves for electric as well as water utilities are typically found to be in the 30 to 45 day range, although 15-day and 60-day levels are sometimes encountered.

RECOMMENDATIONS

It is recommended that Lodi Electric Utility establish an Operating Cash Reserve Fund set at an amount equal to 45 days of its budgeted operating costs in FY07. Establishing operating reserves at this level is consistent with both local and nationwide electric utility practices. (Normally, the most recent fiscal year would serve as the base year, however, because last year was highly untypical the current budget year is proposed to be used as the base year.)

It is also recommended that a Capital Reserve Fund in the amount of $500,000 be established. This is roughly the cost to replace and install a 66/12-kV substation transformer, which represents the largest single contingency on the Lodi Electric Utility system.

It is further recommended that the Rate Stabilization Fund be set in the amount that is reflective of a 20% purchased power increase over a six month period. For FY07, this amount would be $4,200,000.

FISCAL IMPACT

Referring to Table 1 below, at the end of FY 2006, Lodi Electric Utility had approximately $14 Million in various unrestricted accounts or funds. Approximately $10.6 Million of that amount, however, was from bond proceeds which have restrictions placed on their use. The remaining approximate $0.5 Million (Lodi Electric Utility operating reserves) represents less than three days of working capital on projected FY 2007 expenses of approximately $66.5 Million. However, the nearly $3.2 million that

Lodi Electric Utility has "on account" with NCPA can viewed as a contributor to the recommended operating reserve total, since the NCPA Operating Reserve can be used by Lodi Electric to offset NCPA power supply costs and may be returned to the utility upon request. For this reason it is appropriate to consider the NCPA General Operating Reserve toward meeting the recommended 45-day operating reserve requirement as developed in Table 2.

Table 1: Total Cash Available – End of FY2006

Fund Designation	**Current Balances***
Operating Reserve	$ 520,000
Capital Reserve	-0-
Rate Stabilization Reserve	-0-
Debt Service Reserve	-0-
Bond Proceeds Balance**	$ 6,532,000
NCPA Operating Reserve**	$ 3,165,600
Total Cash Available	$10,217,600

* As provided by Lodi Electric Utility

** Restricted Use Funds. Total on hand at end of FY2006 was $10,380,000 -- approximately $6.532 available after prior capital project commitments.

As shown in Table 2 below, establishment of the three reserve funds at the recommended levels would require that an additional $9,215,000 ($12,900,000 - $3,685,000) be set aside. It is not likely that funding at the recommended levels can be accomplished quickly. Lodi Electric Utility will need to consider rate increases or surcharges to convince its customers and rating agencies that it is taking appropriate steps to operate its utility on a stronger financial platform.

Table 2: Fund Reserve Comparison of Current and Recommended Levels Exclusive of Restricted Funds

Fund Designation	**Current Balances***	**Recommended Minimum Balances**	**Shortfalls**
45-Day Operating Reserve**	$ 520,000		
NCPA General Operating	$3,165,000		
	$3,685,000	$ 8,200,000	$ 4,515,000
Capital Reserve	-0-	$ 500,000	$ 500,000
Rate Stabilization Reserve	-0-	$ 4,200,000	$ 4,200,000
Total Cash on hand	$3,685,000	$ 12,900,000	$9,215,000

* As of 6/30/06

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APPENDIX A

CASH FUND RESERVE PRACTICES
OF
SELECTED CALIFORNIA MUNICIPAL UTILITIES

	MUNI #1	MUNI #2	MUNI #3	MUNI #4	MUNI #5
Utility Department	Electric + H_2O	Electric + H_2O	Electric + H_2O	Electric	Electric + H_2O
Formal Reserve Policy set by City Council	Yes	No	No	No	Yes
Co-mingled Funds?	No	No	No	No	No
Operating Reserve?	Yes, 30 days	Yes, undefined	Yes, 45 days	Yes, undefined	Yes, 45.6 days
Capital Reserve?	Yes	No	Yes	No	No